

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 01-0076

Corporate Income Tax

For the Fiscal Years Ending March 31, 1998, 1999, and 2000

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on the date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Gross Income Tax - Disallowance of "special corporation" status

Authority: 45 IAC 1.1-2-12

The taxpayer protests the auditor's disallowance of its "special corporation" status and the imposition of the gross income tax.

II. Tax Administration – Auditor's reliance on auditing technique in the absence of relevant financial records

Authority: IC 6-8.1-5-1; IC6-8.1-4-2

The taxpayer protests the auditor's use of departmental audit experience to arrive at a standard division of income between service and sale of tangible personal property.

III. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

The taxpayer protests the penalty assessed.

STATEMENT OF FACTS

The taxpayer is a contractor engaged in constructing bulk materials handling facilities. The taxpayer is a wholly owned subsidiary of another regular corporation. During the years of the audit period the taxpayer considered itself to be a qualified subchapter S subsidiary (QSUB) because its parent corporation presumably met the qualifications to elect S corporation status. Based upon this belief, the taxpayer filed its Indiana income tax returns as a special corporation, i.e., one exempt from the gross income tax.

The department audited the taxpayer. The auditor disallowed the taxpayer's special corporation status and imposed the gross income tax. At the time of the examination, the taxpayer could not provide the auditor with a division of income between higher rate and lower rate receipts. Based upon departmental audit experience, the auditor assessed 60% of the taxpayer's total Indiana receipts at the higher gross income tax rate and 40% at the lower rate.

The taxpayer protested the imposition of the gross income tax and the imposition of penalty. Further, the taxpayer protested the auditor's use of a standard 60% / 40% division of gross receipts, submitting an amended return for fiscal year ending March 31, 1998 in support of its protest. This amended return presumably reflects the actual division of higher rate and lower rate receipts for this year.

In a letter dated March 6, 2002, the taxpayer conceded its liability for the gross income tax. However, the taxpayer continued to assert the accuracy of the figures contained in the amended return for fiscal year ending March 31, 1998 and continued to protest the imposition of penalty.

I. Gross Income Tax - Disallowance of "special corporation" status

The taxpayer protested the auditor's disallowance of its "special corporation" status and the imposition of the gross income tax. Following review and discussion, the department and the taxpayer resolved this matter. In a letter dated March 6, 2002, the taxpayer conceded its liability for the gross income tax.

FINDING

The taxpayer has withdrawn its protest of this issue.

II. Tax Administration – Auditor's reliance on auditing technique in the absence of relevant financial records

The taxpayer protests the auditor's use of departmental audit experience to arrive at a standard division of income between service income and income derived from the sale of tangible personal property. IC 6-8.1-4-2 (a) (6) states:

The division of audit may: ... employ the use of such devices and techniques as may be necessary to improve audit practices.

Hence, given the absence of financial records during the audit examination, the auditor was justified in employing a standard approach to the division of income. However, in the interim, the taxpayer has submitted an amended return for fiscal year ending March 31, 1998 that purports to contain the actual division of income. The department has determined that the figures contained in it are reasonable, and, accordingly, a supplemental audit has been prepared. In a letter dated March 6, 2002 the taxpayer withdrew its protest of this issue based on the proposed supplemental audit adjustments.

FINDING

The taxpayer has withdrawn its protest of this issue.

III. Tax Administration – Penalty

Prior to being audited by the department, the taxpayer considered itself to be a QSUB for the years of the audit period. Hence, the taxpayer believed it met the qualifications for being an S corporation and filed its income tax returns as a “special corporation.” The auditor determined that the taxpayer was not a QSUB for the years in question and assessed Indiana gross income tax. While the taxpayer has conceded its liability for the gross income tax, it continues to protest the imposition of the negligence penalty.

Administrative Rule 45 IAC 15-11-2 (b) states the following:

“Negligence” on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

In a letter dated February 15, 2001, the taxpayer asserted that it researched the Indiana Code, regulations, rulings, and form instructions, and found only the following statement:

A Company is eligible to file Form IT-20SC if they would be eligible to be an S-Corporation under Federal law pursuant to IRC Section 1361 (b).

The taxpayer does not cite the source of this statement. However, the taxpayer was not eligible to be an S corporation during the years of the audit. Section 1361 (b) (1) (B) of the Internal Revenue Code (IRC) states in pertinent part:

Small business corporation –

- (1) In general – For purposes of this subchapter, the term “small business corporation” means a domestic corporation which is not an ineligible corporation and which does not - ...
 - (B) have as a shareholder a person ... who is not an individual.

The fact that the taxpayer’s sole shareholder was a regular corporation makes the taxpayer ineligible for S corporation status.

Regarding the taxpayer’s argument that it was a QSUB during the audit period because its parent corporation could have elected to be an S corporation, IRC § 1361 (b) (3) states in part,

- (A) In general. Except as provided in regulations prescribed by the Secretary, for purposes of this title –
 - (i) a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and
 - (ii) all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

There is no indication that the parent corporation ever treated all assets, liabilities, etc. of the taxpayer as its own. The fact that the taxpayer filed its own income tax returns for the years of the audit clearly indicates that it was not a QSUB. The taxpayer failed to familiarize itself with those sections of the Internal Revenue Code that provide the qualifications for status as an S corporation or a QSUB. The taxpayer has not established that its failure to timely pay the full amount of tax due was due to reasonable cause and not due to negligence.

FINDING

The taxpayer’s protest is denied.